

House Bill 619 S.L. 2011-390

“Forced Combination Bill”

Jonathan Tart
Fiscal Research Division
Revenue Laws Committee
November 2, 2011



FISCAL RESEARCH DIVISION
A Staff Agency of the North Carolina General Assembly

House Bill 619 S.L. 2011-390

- Enacts rules concerning the Secretary of Revenue's authority to require multistate corporations to file a combined return or to adjust intercompany transactions
- Authorizes Revenue Laws Committee to review the new law and recommend any changes needed
- Authorizes Revenue Laws Committee to recommend whether the new law should apply to pending assessments and requests for refunds

Determining State Income for a Multistate Corporation

- What is the total amount of income that is attributable to the taxpayer?
- How should this income be divided among the states?
- Complex issues because large corporations are made up of a parent company and numerous subsidiary/affiliate companies that do business in many if not all states

Separate Entity Reporting vs. Combined Reporting

Separate Entity Reporting

- Parent company and affiliate companies calculate their income tax as separate taxpayers
- Each company doing business in the state determines its income separately and files its own tax return

Combined Reporting

- Parent company and affiliate companies in unitary business group calculate their income tax as one taxpayer
- Intercompany transactions are ignored

How does NC do it?

Example 1

Company A

- Taxable Income: 10,000
- Apportionment : 50%
- NC Taxable Income: 5,000
- NC Tax due: 350

Company B

- Taxable Income: 10,000
- Apportionment : 5%
- NC Taxable Income: 500
- NC Tax Due: 35

Company A and Company B file separate returns. NC collects a total of \$385 from these two taxpayers under separate entity reporting.

How does NC do it?

Example 2: Company A and Company B are related and have intercompany transaction

Company A

- Income: 10,000
- Intercompany: -4,000
- Taxable Income: 6,000
- Apportionment : 50%
- NC Taxable Income: 3,000
- NC Tax due: 210

Company B

- Income: 10,000
- Intercompany: 4,000
- Taxable Income: 14,000
- Apportionment : 5%
- NC Taxable Income: 700
- NC Tax Due: 49

Company A and Company B file separate returns. NC collects a total of \$259. The intercompany transaction reduced tax collections by \$126 (385-259).

HB 619: Combined report if intercompany transaction doesn't meet economic substance test. Exception: If intercompany transaction involves royalty reporting provision, cannot require combined report

How does North Carolina determine income for a Multistate Corporation?

Without HB 619

- Separate Entity Reporting but,
- Revenue may require combined reporting or adjust intercompany transactions if company does not report true earnings or arbitrarily shifts income.
- Statute provides little guidance

HB 619

- Separate Entity Reporting but,
- Revenue may require combined reporting or adjust intercompany transactions if lack economic substance
- Statute provides criteria to assist in determining whether economic substance test is met

What is economic substance?

An intercompany transaction has economic substance if it meets two tests:

1. The transaction has a business purpose other than tax benefits
2. The transaction has economic effects other than tax benefits

HB 619 provides guidance to assist in determining whether standards are met

Exception for Royalty Reporting Provision

- Under House Bill 619, the Secretary of Revenue cannot require a combined return or adjust intercompany transactions if it limits taxpayer options for reporting royalty income.
- Why the exception? General Assembly passed a law in 2001 to give related companies the option to choose which company reported royalty income.
- Issue for consideration? Strategies have been developed to reduce tax bill using the royalty reporting provision. These transactions are not subject to economic substance test under HB 619.

Should HB 619 be retroactive?

- House Bill 619 is effective for taxable years beginning on or after January 1, 2012
- Should House Bill 619 apply to unresolved cases, which would affect pending assessments and refunds?

Other Issues for Consideration?

- Conforming Changes
- Other Issues?